Joint Committee on Taxation
August 1, 1990
JCX-22-90

PRESENT-LAW TAX RULES AND PROPOSED COMMITTEE AMENDMENT UNDER S. 712, PUERTO RICO STATUS REFERENDUM ACT[1]

(Markup Consideration by Senate Committee on Finance on August 1, 1990)

A. Present-Law Tax Rules

Taxation of individuals

U.S. residents and citizens in general

The United States generally imposes income tax on the worldwide income of U.S. citizens and residents. All U.S. citizens and residents whose gross income for a taxable year is not less than the sum of the personal exemption amount and the basic standard deduction are required to file an annual U.S. individual income tax return.

Nonresident alien individuals are subject to U.S. tax, at ordinary rates, on their net income effectively connected with the conduct of a trade or business in the United States. Such individuals are also subject to a tax (at different rates computed on the basis of gross income) on certain other types of U.S. source income. Generally, Puerto Rico is not included within the United States for purposes of the Internal Revenue Code.

Treatment of foreign source income

In general, U.S. persons (e.g., U.S. residents and U.S.

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[1] S. 712 was reported by the Senate Committee on Energy and Natural Resources on September 6, 1989 (S. Rept. No. 101-120, 101st Cong., 1st Sess.). S. 712 was jointly referred to the Senate Committees on Finance and on Agriculture, Nutrition, and Forestry. The Senate Committee on Finance held hearings on the bill on November 14-15, 1989 and April 26, 1990. (For a more detailed description of present-law tax rules, S. 712 as reported by the Senate Committee on Energy and Natural Resources, and related issues, see Joint Committee on Taxation, Tax Rules Relating to Puerto Rico Under Present Law and Under Statehood, Independence, and Enhanced Commonwealth Status (S. 712, Puerto Rico Status Referendum Act) (JCS-19-89), November 14, 1989.)

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citizens no matter where they reside) are taxed on all their income whether from U.S. or foreign sources. A credit, with limitations, may be claimed for foreign income taxes paid or accrued, or alternatively foreign taxes may be treated as a deduction. For purposes of the Code, Puerto Rico generally is treated as a foreign country, with significant exceptions discussed below.

Code section 911 provides that a U.S. citizen or resident with a tax home abroad may under certain circumstances elect to exclude an amount of foreign earned income from gross income. The maximum exclusion generally is limited to $70,000 per year plus certain housing costs. No deductions, exclusions, or credits are allowed for amounts allocable to this excluded income.

Taxation of U.S. persons residing in Puerto Rico

Under the Jones Act, Puerto Rico is deemed to be a part of the United States for purposes of acquiring U.S. citizenship by place of birth. Thus, a person born in Puerto Rico is typically a U.S. person for U.S. tax purposes. However, section 933 of the Code provides that income derived from sources within Puerto Rico by an individual who is a resident of Puerto Rico generally will be excluded from gross income and exempt from U.S. taxation, even if such resident is a U.S. citizen. Such income generally will be subject to taxation by Puerto Rico. Items of income earned from sources outside of Puerto Rico by U.S. persons who reside in Puerto Rico generally are subject to U.S. taxation.

Estate and gift tax

Under a special rule, a U.S. citizen residing in a possession is treated as a nonresident alien for estate and gift tax purposes only if citizenship was acquired solely by reason of citizenship of, or birth or residence within, the possession. Estate and gift transfers by residents of Puerto Rico that are exempt from Federal estate and gift taxation under these provisions (e.g., transfers of property not situated in the United States) generally are subject to estate and gift taxation in Puerto Rico. Estates of decedents qualifying under this rule are allowed a credit against the estate tax equal to the greater of $13,000 or that proportion of $46,800 which the value of that part of the decedent's gross estate which at the time of death was situated in the United States bears to the value of the entire gross estate wherever situated.

Taxation of corporations

Puerto Rico corporations

A corporation organized under the laws of Puerto Rico is

a foreign corporation and is subject only to those U.S. taxes imposed on foreign corporations in general. However, Puerto Rico corporations generally are subject to income taxes in Puerto Rico. Currently, the minimum rate is 22 percent, and the highest marginal rate for 1990 is 39 percent, for 1991 is 37 percent, and for 1992 and beyond is 35 percent.

U.S. corporations--in general

U.S. corporations are subject to U.S. income tax on their worldwide income. Foreign income taxes paid or accrued are creditable, with limitations, against U.S. tax liability or alternatively may be deducted in calculating taxable income. Special rules apply to income derived in U.S. possessions by certain domestic corporations.

Possession tax credit (section 936)

Under present law, certain domestic corporations with business operations in U.S. possessions (including, for this purpose, Puerto Rico and the U.S. Virgin Islands) may elect under Code section 936 to generally eliminate the U.S. tax (including the alternative minimum tax) on certain foreign source income which is related to their operations in the possessions. Currently, a majority of corporations that benefit from the possession tax credit have established operations in Puerto Rico. Income that is not subject to U.S. tax under this provision includes income that is derived either from the active conduct of a trade or business within a U.S. possession or from certain investments in the possessions or in certain Caribbean Basin countries, which investments generate qualified possession source investment income ("QPSII"). The section 936 credit spares the electing corporation U.S. tax whether or not it pays income tax to the possession.

In order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period, and at least 80 percent of the corporation's gross income must be derived from sources within a possession during that same period.

Three alternative methods are provided for allocating income from intangible property between a corporation electing section 936 treatment and its U.S. shareholders. These methods include (1) a general rule that prohibits an electing corporation from earning any return on intangible property, (2) a cost sharing method which requires an electing corporation to reimburse other members of its affiliated group of corporations for a portion of the current research and development expenses incurred by the group, and (3) a profit split approach which generally permits no more

than 50 percent of an affiliated group of U.S. corporations' combined taxable income derived from sales of products which are manufactured in a U.S. possession to be allocated to the electing corporation. For purposes of computing the cost sharing amount under the cost sharing method, an electing corporation's current share of the affiliated group's research and development expenses is the greater of the total amount of such expenses in the electing corporation's product area multiplied by 110 percent of the proportion of its sales as compared to total product area sales of the group, or the amount of the royalty payment or inclusion that would be required under sections 367(d) and 482 with respect to intangible assets which the electing corporation is treated as owning under the cost sharing method, were the electing corporation a foreign corporation.

Dividends paid by a corporation that has elected section 936 treatment to its U.S. shareholder may qualify for the deduction for dividends received from a domestic corporation (sec. 243). In cases where at least 80 percent of the stock of the electing corporation is owned by a single domestic corporation, the electing corporation's possession source income generally can be distributed without incurring any regular U.S. income tax. However, such a dividend constitutes adjusted current earnings of the shareholder for purposes of computing the alternative minimum tax.

U.S. taxation of Puerto Rico obligations

Section 103 of the Code provides that the interest on a bond issued by the Commonwealth of Puerto Rico or its municipalities generally is exempt from U.S. income tax in the same manner as interest on a bond issued by a State. The exemption does not apply to any bond that is a non-qualified private activity bond (within the meaning of section 141).

Low-income housing credit

A low-income housing credit is allowed against U.S. income tax liability. The credit is allowed in annual installments over 10 years to the owners of qualified low-income rental housing, including housing located in a U.S. possession. In addition to maintaining prescribed percentages of low-income units and satisfying other requirements, the building owners must receive a credit allocation from the appropriate credit authority (such as a State or Puerto Rico), except in the case of housing projects financed with tax-exempt bonds. In general, the authority of housing credit agencies to allocate low income housing credits expires December 31, 1990.

Excise taxes

U.S. Excise taxes on Puerto Rican goods imported

into the United States

U.S. excise taxes generally do not apply within Puerto Rico. However, U.S. excise taxes equal to the taxes on domestically produced articles are imposed on articles brought into the United States from Puerto Rico.

Cover overs of excise taxes on Puerto Rican products

Revenues collected from the tax on certain articles coming into the United States from Puerto Rico generally are "covered over" (i.e., paid) to the Puerto Rican Treasury. With respect to otherwise eligible excise taxes imposed on articles not containing distilled spirits, revenues are covered over to Puerto Rico only if the cost or value of materials produced in Puerto Rico plus the direct costs of processing operations performed in Puerto Rico equal at least 50 percent of the value of the article at the time it is brought into the United States (sec. 7652(d)(1)). Moreover, no cover over is permitted on such articles if Puerto Rico provides a direct or indirect subsidy with respect to the article which is unlike the subsidies which Puerto Rico generally offers to industries producing articles not subject to Federal excise tax (sec. 7652(d)(2)).

With respect to Federal excise taxes imposed on articles containing distilled spirits that are manufactured in Puerto Rico and shipped into the United States, revenues are covered over to the Puerto Rican Treasury only if at least 92 percent of the alcoholic content of such articles is attributable to rum (sec. 7652(c)). The amount of excise taxes covered over to Puerto Rico from such articles cannot exceed $10.50 per proof gallon (sec. 7652(f)).

A special excise tax rule also applies when articles manufactured in the United States are shipped to Puerto Rico (sec. 7653). In such cases, the articles are exempt from Federal excise taxes and, upon being entered in Puerto Rico, are subject to a tax equal in rate and amount to the excise tax imposed in Puerto Rico upon similar articles of Puerto Rican manufacture.

Cover overs of excise taxes on rum imported from other countries

A provision of the Code added by the Caribbean Basin Economic Recovery Act (Caribbean Basin Initiative) provides a special rule for excise taxes collected on rum imported into the United States from any country. Such excise taxes are covered over to the treasuries of Puerto Rico and the Virgin Islands, under a formula prescribed by the U.S. Treasury Department for the division of such tax collections between Puerto Rico and the Virgin Islands (sec. 7652(e)). This formula currently results in approximately 88 percent of

revenues from rum excise taxes being covered over to Puerto Rico and the remainder of such revenues being covered over to the Virgin Islands.

Tax treaties

There are no bilateral tax treaties between Puerto Rico and any foreign country. In addition, U.S. treaties typically do not include Puerto Rico in the definition of "United States" for treaty purposes. Moreover, although Puerto Rican individuals are typically U.S. citizens, U.S. treaties often do not extend to them the same reductions of foreign source country tax to which a resident of one of the 50 States or the District of Columbia would be entitled under a U.S. tax treaty.

B. Description of S. 712 and Explanation of Amendment

1. In general

The bill (S. 712), as reported by the Senate Committee on Energy and Natural Resources, provides for a referendum to be held on June 4, 1991 (and if necessary for a runoff referendum to be held on August 6, 1991), or on a date (or dates) during the summer of 1991 as may be mutually agreed by the three principal political parties of Puerto Rico. The purpose of the referendum will be to determine whether Puerto Rico is to become a U.S. State, become an independent country, or remain in a commonwealth relationship with the United States. The procedures for implementing whichever status option receives a majority (as certified to the President and the Congress of the United States by the Governor of Puerto Rico) are detailed in titles II (which applies if statehood is chosen), III (independence), and IV (commonwealth) of the bill.

The proposed Committee amendment ("the amendment") replaces those provisions of the bill that are within the jurisdiction of the Finance Committee. In addition, where a bill provision relates to matters both within and without the Finance Committee's jurisdiction, the amendment provides modifications with respect to matters within the Finance Committee's jurisdiction. This markup document describes those bill provisions that are modified but not deleted, and describes all provisions of the Finance Committee amendment.

It is expected that the Chairman of the Finance Committee will offer an amendment to the bill on the Senate floor to accommodate action by the Senate Committee on Agriculture, Nutrition, and Forestry with respect to the Food Stamps Program, to the extent consistent with the approach adopted by the Finance Committee.

2. Title II (Statehood)

Description of the bill

Should statehood be certified as having obtained a majority of the votes cast in the referendum, the Commonwealth of Puerto Rico would be admitted as a State on an equal footing with the other States (bill sec. 201). Upon admission of Puerto Rico into the Union, all of the local laws then in force in Puerto Rico would continue in force and effect (except as modified or changed by the bill) subject to repeal or amendment by the Puerto Rican legislature (bill sec. 208(a)).

Explanation of Amendment

In general

Under the amendment, the date on which Puerto Rico would be admitted as a State would be changed to the first day of January of the fifth calendar year beginning after the certification of the referendum in favor of statehood. Thus, for example, if such certification occurred during 1991, Puerto Rico would become a State as of January 1, 1996. In conformity with this provision of the amendment, the date on which the persons elected to represent Puerto Rico as U.S. Senators and members of the U.S. House of Representatives would be entitled to seats in Congress and to all the rights and privileges of Senators and Representatives of the other States in Congress would be changed to the date on which Puerto Rico's admission as a State becomes effective.

Application of U.S. tax laws to Puerto Rico

The amendment would provide for a transition period, ending on admission of Puerto Rico to statehood, immediately following which the Federal internal revenue laws not presently applicable to Puerto Rico would be fully applicable to Puerto Rico. The effect of these laws generally would be phased in ratably during the transition periods set forth below.

Excise taxes.--In the case of excise taxes, the transition period would commence with the second calendar year beginning after the certification of the referendum. Thus, excise taxes would be imposed on articles sold on or after the first day of that year. With respect to the imposition of U.S. excise taxes on goods consumed in Puerto Rico, a special rule would apply for goods which are manufactured in or imported into Puerto Rico before the first day of the second calendar year beginning after certification of the referendum, and which are held on such date for sale by any person beyond the point tax generally would have been imposed (i.e., applicable floor stocks taxes).

Income and employment taxes.--In the case of income and

employment taxes, the transition period would commence with a taxpayer's second taxable year beginning after the certification of the referendum.

Estate and gift taxes.--In the case of estate and gift taxes, there would be no transition period under the amendment. Thus, estate and gift taxes would be imposed with respect to decedents dying on or after, or for gifts made on or after, the first day of January of the fifth calendar year beginning after the certification of the referendum.

If, for example, the certification of the referendum in favor of statehood occurs on October 31, 1991, the imposition of Federal excise taxes on goods consumed in Puerto Rico would begin as of January 1, 1993. The imposition of Federal income taxes in this case would commence with a taxpayer's second taxable year that begins after October 31, 1991; thus, in the case of a corporation with a taxable year that begins on November 1, these taxes would first be imposed with respect to its taxable year beginning November 1, 1992. The U.S. estate and gift taxes in this case would apply to decedents dying, or for gifts made, on or after January 1, 1996. This provision of the amendment would be applicable, for example, to the U.S. individual income tax and the U.S. estate and gift taxes on individuals resident in Puerto Rico, to the U.S. corporate income tax on companies organized under the laws of Puerto Rico, and to the U.S. excise taxes on goods consumed in Puerto Rico.

Transition periods

In general.--The phase-in of the Federal internal revenue laws generally would be implemented as follows: During the first year that a tax would apply (under the rules as described above), Puerto Rico and its residents would be treated no differently than the United States and its residents to the extent of 25 percent of full U.S. tax liability on income not currently taxed by the United States. (For example, assume a U.S. resident earning $100 of U.S. wages would pay $28 of U.S. tax. Under the amendment, a Puerto Rico resident with the same Puerto Rico wages would pay $7 of U.S. tax under this rule.) The amendment does not otherwise affect the tax treatment of Puerto Rico persons or Puerto Rico source income; for example, it does not otherwise affect items such as income of a Puerto Rico resident from sources outside Puerto Rico, or income of a U.S. resident from sources within Puerto Rico.

Generally, the percentage referred to above would be increased to 50 percent for the second year of the transition period, to 75 percent for the third year of the transition period, and to 100 percent for the fourth year of the transition period and thereafter.

A special rule applies in the case of income tax, however, if some portion of the third taxable year of the transition period falls after statehood becomes effective. Under this special rule, a pro-rata portion of income from that year is subject to 100-percent taxation under the Internal Revenue Code. Thus, for a fiscal year taxpayer with a taxable year ending June 30, one-half of the income from the third year of the transition period would be subject to full Federal income tax if that year ended after statehood became effective. This special rule would only affect taxpayers whose taxable years end between January 1 and the day of the year on which certification of the referendum results occurs.

Similar phase-in rules would apply during the transition period to refundable tax credits, such as the earned income tax credit.

Section 936.--The amendment would provide for a similar transition period for the phase-out of the possession tax credit as it applies to section 936 corporations with operations in Puerto Rico. Under this provision of the amendment, the section 936 credit generally would be phased out ratably over a four-year period commencing in the section 936 corporation's second taxable year that begins after the certification of the results of the referendum. That is, the amount of the section 936 credit available with respect to income or investments from activity in Puerto Rico would be reduced to 75 percent of the amount of the credit available under present law for a section 936 company's second taxable year beginning after such certification. The applicable percentage would be 50 percent for the third taxable year, and generally 25 percent for the fourth taxable year beginning after such date. Commencing with the fifth taxable year beginning after certification of the referendum, the section 936 credit would no longer be available with respect to such income or investments.

A special rule would apply, however, if some portion of the taxpayer's fourth taxable year beginning after certification of the referendum falls after statehood becomes effective. Under this special rule, the section 936 credit would not be available with respect to a pro-rata portion of income attributable to operations in Puerto Rico for such a year. Thus, for a fiscal year taxpayer with a taxable year ending June 30, one-half of the income from the fourth taxable year beginning after certification of the referendum would not qualify for any section 936 credit, if that year ended after statehood became effective. This special rule would only affect taxpayers whose taxable years end between January 1 and the day of the year on which certification of the referendum results occurs.

The section 936 credit would be available only to

corporations that are entitled to section 936 benefits for the taxable year that includes the date of certification of the referendum. Moreover, the amount of allowable section 936 credits (before reduction by the applicable phase-out percentage) would be limited to 130 percent of the average amount of section 936 credits taken by the taxpayer in the three most recent taxable years ending prior to August 1, 1990 (or such shorter period for which credits were taken in the case of a taxpayer that did not exist or did not take section 936 credits during those three years).

Cover overs of taxes

The amendment would provide that the present cover over of excise taxes and customs duties by the United States Treasury to Puerto Rico would continue during years prior to Puerto Rico's admittance as a State. The amendment would further provide that during the transition period for imposition of the U.S. income and excise taxes, any newly imposed income or excise taxes would be covered over to Puerto Rico. Moreover, a portion of the revenues generated during the transition period from the phase out of section 936 may be covered over to Puerto Rico. The portion so covered over for any year during the transition period would be an amount (if any) necessary to make the provisions of the bill related to statehood revenue neutral to the U.S. Treasury for that year.[2]

Other rules

In order to implement the various phase-ins and phase-outs described above, the amendment provides certain special rules.

Treatment of Puerto Rico as a State for tax purposes

The amendment provides that beginning in the year during which application of the Federal tax laws are extended to Puerto Rico, Puerto Rico generally would be considered a State for purposes of the Internal Revenue Code to the extent of the phase-in. Thus, for example, corporations incorporated under the laws of Puerto Rico would be considered U.S. corporations and would be subject to U.S. tax (at the appropriate phase-in level) on their worldwide

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[2] It is anticipated that, prior to any cover over of revenues generated during the transition period from the phase out of section 936, the revenues would first be utilized for the purpose of funding any expansion of the Food Stamps program in Puerto Rico which may result from amendments to S. 712 by the Committee on Agriculture, Nutrition, and Forestry.

income. If, however, the stock of a Puerto Rico corporation were owned by a U.S. person or persons, the portion of the earnings of the corporation not subject to U.S. tax because of the phase-in rules would continue to be subject to the various anti-deferral statutes of the Code such as the subpart F income rules, the foreign personal holding company rules, or the passive foreign investment company rules.

Sourcing of income

Income earned from sources within Puerto Rico generally would be considered U.S. source income for purposes of the U.S. tax liability being phased in (except where necessary to properly implement the phase-out of the possession tax credit). This rule, for example, would cause income earned from sources within Puerto Rico by Puerto Rico residents or other non-U.S. residents to become subject to U.S. taxing jurisdiction (although the overall U.S. tax liability on such income would be limited by the phase-in rules).

Treatment of taxes paid to Puerto Rico

Taxes paid to Puerto Rico during the transition period would be treated as taxes paid to a State for purposes of the U.S. tax liability being phased in. Thus, no foreign tax credit would be allowed for such taxes in determining U.S. tax liability under the phase-in percentage. However, a deduction for the amount of such taxes generally would be permitted for that purpose to the extent provided under Code section 164.

Code section 933

For purposes of application of the U.S. individual income tax to a person resident in Puerto Rico, the amendment would repeal Code section 933, effective as of that person's second taxable year beginning after the certification of the referendum. As a result, such a person would be required to include income from sources within Puerto Rico in his or her U.S. individual income tax return. The tax on that income, however, would be limited pursuant to the phase-in rules.

Treatment of persons residing in Puerto Rico for U.S. estate and gift tax purposes

Additionally, the amendment would provide that the special rules contained in Code sections 2209 and 2501(c) (which treat certain U.S. citizens who reside in U.S. possessions as neither residents nor citizens of the United States for purposes of the estate and gift taxes) would be amended so that such treatment would not be granted to persons residing in Puerto Rico. This provision of the amendment would be effective for decedents dying after, or for gifts made after, the first day of the fifth calendar

year beginning after the certification of the results of the referendum.

Excise taxes on goods shipped between the United States and U.S. possessions

The amendment also would terminate application to Puerto Rico of the special rules of sections 5001, 5314, and 7653 of the Code, which pertain to the excise taxation of goods shipped between the United States and specified U.S. possessions. This provision of the amendment would be effective as of the first day of the second calendar year beginning after the certification of the results of the referendum.

Authority to develop other transitional rules

In addition to the special rules specified above, the amendment contains a provision that would permit Congress to explicitly reserve the authority to enact any appropriate transitional rules that would be necessary to properly implement the phase-in of the U.S. tax system in Puerto Rico and the phase-out of the section 936 tax credit. Moreover, the amendment would authorize Treasury to promulgate and implement such regulations as are necessary for this purpose.

3. Title III (Independence)

Description of the Bill

Should independence be certified as having obtained a majority of the votes cast in the referendum, Puerto Rico would convene a constitutional convention for the purpose of drafting a constitution for post-independence Puerto Rico (to be known as the "Republic of Puerto Rico") (bill sec. 301). Subsequent to the ratification of the resulting constitution by the people of Puerto Rico, and the election of such officers as may be provided for in such constitution, the President of the United States would by proclamation withdraw U.S. sovereignty over the territory and people of Puerto Rico, effective upon the issuance of a Proclamation of Independence by the Republic of Puerto Rico (bill sec. 307). Upon the issuance of such Proclamation of Independence, the Republic of Puerto Rico would become a sovereign country.

Upon the certification of the referendum in favor of independence, Puerto Rico would no longer be treated as part of the United States for purposes of acquiring U.S. citizenship by place of birth under the Jones Act and the Immigration and Nationality Act (bill sec. 311(b)). In addition, an individual born outside the United States would not acquire U.S. citizenship at birth if the parents of that individual acquired U.S. citizenship solely by virtue of being born in Puerto Rico prior to the Proclamation of

Independence pursuant to the provisions of the Jones Act and the Immigration and Nationality Act (bill sec. 311(c)).

Explanation of Amendment

General tax treatment

The amendment generally would treat the Republic of Puerto Rico as a foreign country and not as a part of the United States for all tax purposes, effective upon Proclamation of Independence, except as specifically provided. Accordingly, Puerto Rico generally would be excluded from tax treatment in the Code that currently pertains specifically to Puerto Rico or other U.S. possessions.

Phaseout of section 936

The amendment generally would permit the existing benefits of section 936 of the Code to Puerto Rico operations and investments to be phased out on a straight-line basis over a four-year period (beginning with the second taxable year that begins after the certification of the referendum in favor of independence). For example, if the referendum is certified in favor of independence during calendar year 1991, the amount of the tax credit allowed to a calendar-year taxpayer under section 936 would be reduced by 25 percent during 1993, by 50 percent during 1994, and by 75 percent during 1995, and would be eliminated entirely beginning in 1996.

Benefits described above would be available only to corporations that are entitled to section 936 benefits for the taxable year that includes the date of certification of the referendum. Moreover, the amount of allowable section 936 credits (before reduction by the applicable phaseout percentage) would be limited to 130 percent of the average amount of section 936 credits taken by the taxpayer in the three most recent taxable years ending prior to August 1, 1990 (or such shorter period for which credits were taken in the case of a taxpayer that did not exist or did not take section 936 credits during those three years).

Treatment of certain U.S. citizens resident in Puerto Rico

Under the amendment, an individual who is a bona fide resident of the Republic of Puerto Rico after independence would continue to be eligible, under certain circumstances, for the exclusion currently provided under section 933 of the Code for income from sources within Puerto Rico. The benefits of section 933 would be available for a taxable year only for such a resident of the Republic of Puerto Rico (1) who is a citizen of the United States solely by virtue of either being born in Puerto Rico pursuant to the provisions

of the Jones Act and the Immigration and Nationality Act, or being born to parents who themselves are citizens of the United States solely by virtue of being born in Puerto Rico pursuant to the provisions of the Jones Act and the Immigration and Nationality Act, or both; and (2) whose taxable income for the taxable year comprises earned income of an amount not exceeding the limitation on the foreign earned income exclusion applicable for that year, and unearned income of an amount not exceeding the sum of the applicable standard deduction and the applicable personal exemption(s). In all other cases, a resident of Puerto Rico would be ineligible for treatment under section 933 for any period, after the date of the Proclamation of Independence, during which the foregoing thresholds are exceeded.

For estate and gift tax purposes, all U.S. citizens resident in the Republic of Puerto Rico would be treated the same as U.S. citizens resident in any other foreign country.

Application of U.S. excise taxation

Under the amendment, the cover over to the Treasury of Puerto Rico of excise taxes collected by the United States on articles coming into the United States from Puerto Rico and on rum imported into the United States would be phased out over five years (the first five years beginning after the certification of the referendum). For example, if the referendum is certified in favor of independence during 1991, the amount of excise tax covered over to Puerto Rico would be 80 percent of the amount otherwise due during 1992, 60 percent during 1993, 40 percent during 1994, 20 percent during 1995, and none beginning in 1996.

Application of low-income housing credit

The amendment would grandfather low-income housing credits for projects located in Puerto Rico that (1) receive credit allocations from the Puerto Rico housing credit ceiling prior to the end of the calendar year during which the referendum is certified, or (2) would have required such an allocation but for their use of tax-exempt bond financing issued prior to the end of the calendar year during which the referendum is certified. Regardless of any possible future extension of the low-income housing credit generally, no low-income housing credit amount would be available for allocation (other than a carryover credit allocation) after the end of the calendar year during which the referendum is certified, and no credit would be available for projects financed with tax-exempt bonds issued after the end of the calendar year during which the referendum is certified.

Treatment of tax-exempt bonds issued by Puerto Rico

The amendment would provide that interest on originally

tax-exempt bonds issued by Puerto Rico and its local governments prior to the date of certification of the referendum and outstanding on the date of certification of the referendum would remain tax-exempt in the same manner as if Puerto Rico were a State or a commonwealth.

In addition, the amendment would permit Puerto Rico to continue to issue tax-exempt bonds (both governmental and qualified private activity) as provided under present law for a period of five years, beginning on the date of certification of the referendum.

4. Title IV (Commonwealth)

Description of the Bill

The bill generally would amend the rules of both the House and the Senate to expedite review of certain recommendations of the Puerto Rican Government (where such recommendations are adopted by the Puerto Rico legislature and that fact is certified by the Governor to the Speaker of the U.S. House of Representatives and the President of the Senate) that particular Federal laws should not apply to Puerto Rico (bill sec. 403(a) and (b)).

These provisions would not apply, however, to any Federal statutory law (1) establishing grants or services to individual U.S. citizens, (2) relating to citizenship, or (3) pertaining to foreign relations, defense, or national security (bill sec. 403(c)).

The bill also sets forth a mechanism under which the Governor of Puerto Rico could require agency review and judicial review of Federal regulations which apply to Puerto Rico but which the Governor determines are inconsistent with the policy, set forth in the bill, of enhancing the Commonwealth relationship to enable the people of Puerto Rico to accelerate their economic and social development, to attain maximum cultural autonomy, and in matters of government to take into account local conditions in Puerto Rico (bill secs. 402(b) and 404).

The bill provides that the Governor of Puerto Rico may enter into international agreements to promote the international interests of Puerto Rico as authorized by the President of the United States and consistent with the laws and international obligations of the United States (bill sec. 403(d)).

Explanation of Amendment

The amendment would provide that the provisions regarding expedited Congressional review (bill sec. 403(a) and (b)), the provision regarding Puerto Rican international

agreements (bill sec. 403(d)), and the provisions regarding regulatory review (bill sec. 404) would not apply to any Federal law or provision thereof, or any agency action, relating to matters that would be within the jurisdiction of the Senate Finance Committee if they were the subject of legislation.

The amendment would change the requirement that, in order to qualify for the section 936 credit, a domestic corporation must derive at least 75 percent of its gross income from the active conduct of a trade or business within a U.S. possession over a three-year period (Code sec. 936(a)(2)(B)). Effective for a corporation's fourth taxable year beginning after certification of the referendum in favor of commonwealth, the applicable percentage under the amendment is 80 percent. Effective for taxable years beginning after a corporation's fourth taxable year beginning after certification of the referendum, the applicable percentage under the amendment is 85 percent.

The amendment further would provide that cover overs from the United States to Puerto Rico of excise taxes collected by the United States on articles coming into the United States from Puerto Rico, and on rum imported into the United States, as provided under current law, and cover overs from the United States to Puerto Rico of customs duties and equivalency payments on alcohol, would be phased out over a period beginning after certification of the referendum. For each year prior to full elimination of the cover over, the total cover over would be reduced by an amount sufficient to equal the sum of the increases in social spending programs covered by the amendment, less the increases in federal tax revenues due to the change in the active business requirement in section 936 (as applied to section 936 as then in force) as described above. After 3 such years of reductions in the cover over, the cover over would be eliminated.

Finally, the amendment would provide for an annual limit on incremental spending for years in which the cover over has been eliminated. The annual cap would be the limit on each year's excess of the levels of federal funding for programs affected by the bill over the spending under such programs under the law in effect on August 1, 1990. The cap would be set by reference to estimates to be regularly computed by the Treasury Department. Each year's cap would equal the sum of the increases in federal tax revenues for that year (as so estimated) due to: (1) the change in the active business requirement in section 936 (as applied to section 936 as then in force) as described above; and (2) the elimination of the cover overs as explained above.